http://blogs.wsj.com/indiarealtime/2013/02/08/we-know-this-year-is-bad-what-about-next/

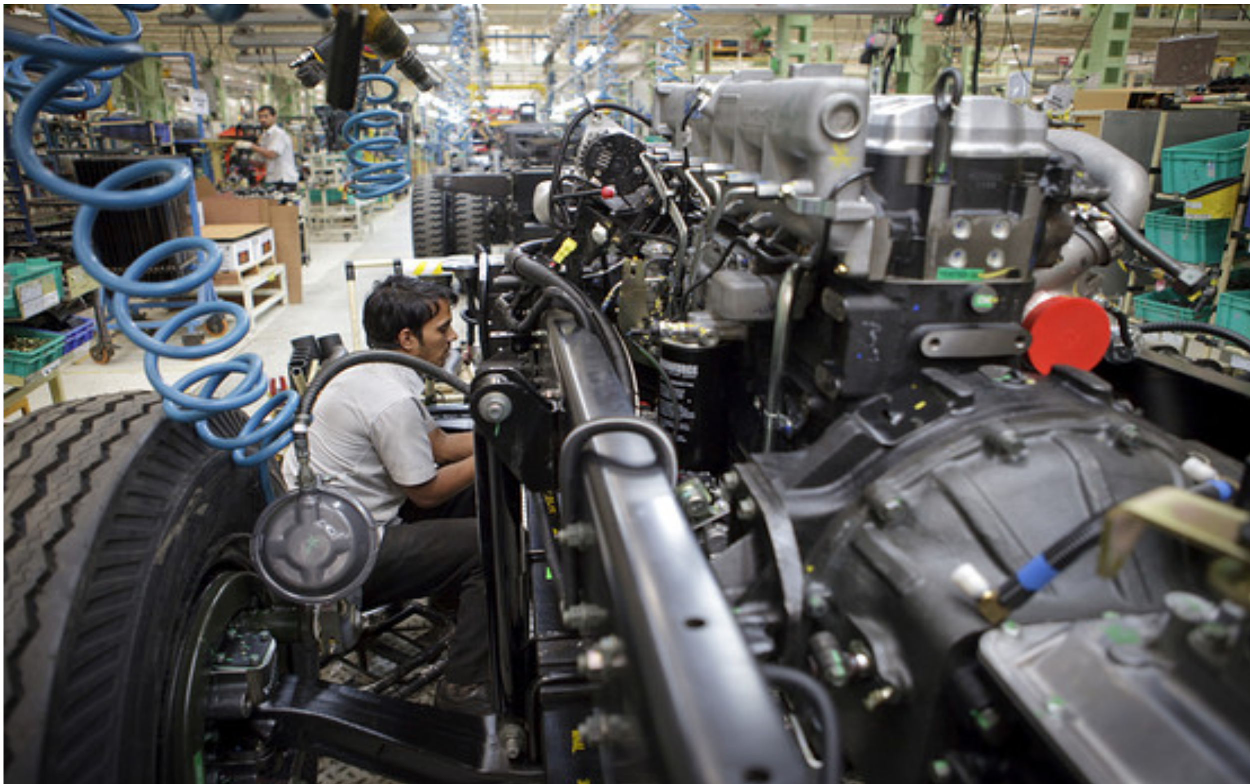
The Wall Street Journal

INDIAREALTIME
The daily pulse of the world's largest democracy

January 8, 2013, 4:25 PM

We Know This Year Is Bad, What About Next?

By Kunal Kumar Kundu



Kuni Takahashi/Bloomberg NewsImages

If the data from Central Statistical Organization is correct, the malaise of economic slowdown is far deeper than anticipated, says Kunal Kumar Kundu.

So, the Central Statistical Organization says we're facing 5% economic growth in the year that ends in a few weeks, which implies a growth rate since September of just 4.6%.

The impact of the drought on agriculture is clearly visible in that slowdown and manufacturing is expected to grow by less than 2% because of tepid domestic demand and shrinking export volumes.

This data, if correct, implies that the malaise is far deeper than anticipated, with even the service sector recording its slowest growth in over a decade. The recovery in the year that starts April 1 is, therefore, is likely to be modest.

This data also confirms that the high twin deficits — fiscal and current account — will continue to challenge India as subsidies continue to rise and lower demand hits the collection of indirect taxes such as sales tax and import and export duties.

As a result, total indirect tax collection (net of subsidies which those taxes often fund) is estimated to have contracted by nearly 19% this year, the second-highest contraction ever, exceeded only by a contraction of 27% during 2008-09. Back then, India was stimulating the economy amid the global financial crisis by reducing rates of indirect tax while continuing to spend heavily on the social sector.

India's fiscal deficit, therefore, is unlikely to remain contained within the revised target of 5.3% of Gross Domestic Product, as the GDP itself is likely to be lower than expected while some proposed spending cuts might not materialize.

The bigger threat, of course, is the current account deficit. Reserve Bank of India data shows that for the quarter to the end of September, India's current account deficit touched $22.3 billion, amounting to 5.4% of GDP, the highest ever recorded and up from $16.4 billion the previous quarter.

This has been caused by a sharp deterioration in balance of trade despite falling imports because exports contracted even more. If the monthly trade balance data is any indicator, the deficit will likely be even higher during the three months to the end of December.

Even during the coming financial year, the specter of twin deficits will haunt India. In the recent monetary policy meeting, the RBI governor expressed his concern about the current account deficit in no uncertain terms as the external environment remains fragile, especially in Europe and the U.S.

As a result, not only are India's exports likely to suffer, there is a possibility of a reversal in portfolio flows. This will put further pressure on the rupee. That may not help exports as much as you might think because external demand remains muted. But it will make India's imports, especially oil, will become more expensive, driving inflation.

Inflation may also get a push from the general elections expected in early 2014 as the government opens the spending taps to appeal to voters.

So there is every reason to believe that the fiscal deficit for 2013-14 will not be contained within the target set by the finance ministry as populist spending rises.

On the other hand, the slowdown in investment spending has gathered momentum and cannot be reversed easily. There has been little tangible increase in spending on infrastructure, for instance, as factors outside of interest rates continue to weigh on companies, such as delayed project approvals, slow project implementation, electricity shortages and the general poor state of governance.

The only positive impact of lower interest rates, as we recently experienced, is the help it will give distressed companies, perhaps keeping in check non-performing assets.

Overall, we have heard some promising policy announcements from the government and there are signs growth will pick up a bit in the coming year. But let's not get overexcited: GDP growth in the year starting April 1 will likely hover around 6%.

Kunal Kumar Kundu is senior economist at RGE India, based in New Delhi. The views expressed are his own.